

Donald L Kohn: Global imbalances

Speech by Mr Donald L Kohn, Vice-Chairman of the Board of Governors of the Federal Reserve System, at the high-level conference on the International Monetary System, Zurich, 11 May 2010.

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As the global economy continues to heal from the devastation wrought by the financial crisis, we must not lose sight of our collective responsibility to ensure that the conditions that gave rise to the crisis are not repeated. On this score, many efforts are under way to promote a more resilient global financial system, but clearly much more remains to be done. In my remarks today, I will focus on global current account (or, external) imbalances, their role in contributing to vulnerabilities in the global economy, and policies that should be undertaken to ensure that the ongoing recovery is built on a solid and durable foundation.¹

If we are to avoid repeating our mistakes, we must learn the right lessons from experience. Sorting through the many complex factors that led to the global financial crisis is no easy task. Although I will argue that global imbalances did contribute to the crisis, it is important to acknowledge that some countries run current account deficits for sound economic reasons while others run current account surpluses. To the extent that global imbalances reflect the efficient allocation of capital and distribution of risk across countries, they support a well-functioning global economy. Thus, our policy actions and reactions should not seek to reduce imbalances for their own sake. Rather, our aim should be to address the imbalances that emerge from or contribute to economic distortions or the mispricing of risks, which thereby foster vulnerabilities in the international financial system and threaten sudden and disruptive reversals.

Large and growing global imbalances were a perennial topic in meetings of international policymakers for years prior to the crisis because they were seen as threat to the global economy. From 1996 to 2006, the U.S. current account deficit widened dramatically, from about 1-1/2 percent of gross domestic product (GDP) to 6 percent. This widening primarily reflected a fall in domestic saving, as domestic expenditures became increasingly reliant on borrowing from abroad.²

The counterpart to the rising U.S. deficit was a surge in the current account surpluses of other countries. In some Asian emerging market economies, current account surpluses arose as domestic investment collapsed after the financial crisis of the late 1990s, and domestic demand in those countries never recovered enough to absorb their strong saving. For China, investment spending was very strong, but it was outpaced by even greater increases in saving, reflecting, among other factors, the weak social safety net and an underdeveloped financial sector. In these countries, economic growth heavily depended on external demand, in part reflecting policies to keep exchange rates artificially low through intervention in currency markets. To some extent, the resulting rapid accumulation of official reserves was welcomed as a buffer against the possibility of another sudden reversal of capital flows, as had occurred in the 1990s. But by resisting appreciation of their currencies, these countries, to some degree, circumvented the usual balancing mechanism for economies that run increasingly large current account surpluses. Germany and Japan significantly depended on

¹ The views expressed in these remarks are my own and not necessarily those of my colleagues on the Board of Governors. Trevor Reeve of the Board's staff contributed to these remarks.

² By 2006, the personal saving rate in the United States had declined to 2-1/2 percent, well below the 8 percent average between 1975 and 1995. The U.S. federal fiscal balance moved from a surplus of 2-1/2 percent of GDP in 2000 to a deficit of almost 2 percent in 2006.

exports as a source of economic growth and ran large current account surpluses as well. Finally, surpluses of oil exporters rose sharply with the escalation in oil prices, as their spending lagged rapid income gains.

As a result of this pattern of surpluses and deficits, capital flowed strongly to the United States from rapidly growing emerging market economies and some advanced economies. Observers feared that, at some point, investors would decide they had enough dollar assets in their portfolios and pull back abruptly from financing the burgeoning U.S. current account deficit, triggering a sharp decline in the dollar, a spike in interest rates, and widespread economic distress.

Discussions among policymakers at that time focused on reducing current account imbalances to stave off such stresses.³ The United States was encouraged to increase national saving, both public and private. Countries with persistent current account surpluses were encouraged to reduce their dependence on external demand by implementing structural reforms to boost domestic demand, including investing in social programs and infrastructure and reforming labor, product, and financial markets. It was understood that by reducing distortions, these reforms might also boost productivity and improve macroeconomic performance. For some countries, especially China, increasing the flexibility of exchange rates was a key policy recommendation. Despite the considerable attention paid to these issues, limited progress was made in actually implementing this agenda or in reducing global imbalances.

As is well known, the crisis did not follow this script. In the event, the dollar weakened in the years leading up to the onset of the crisis in 2007, but once the crisis deepened, the dollar was pushed up sharply by safe-haven flows as investors sought refuge in U.S. Treasury securities from dysfunctional markets and stressed institutions around the world. Adding to upward pressures on the dollar was a severe dollar funding shortage that arose because global banks had been funding long-term asset positions with short-term dollar borrowing in wholesale markets, resulting in a significant funding crunch when these markets froze up.

Instead, the main causes of the crisis originated in the financial sector and stemmed from a widespread underappreciation and underpricing of risk. Failures of risk-management systems, incentive problems in securitization and compensation structures, and regulatory shortcomings and gaps led to a vulnerable, overleveraged financial system with inadequate capital and liquidity buffers. These problems were amplified by the eagerness of U.S. households to take on huge amounts of mortgage debt and of lenders to advance them the credit, justified by overly optimistic expectations for house price appreciation as the real estate boom progressed.

But these financial sector problems were enabled, if not encouraged, by developments in the global economy. The capital outflows associated with the persistent current account surpluses were large even in net terms and, combined with relatively restrained business capital spending in many advanced economies (including the United States), put downward pressure on real interest rates globally.⁴

From a purely theoretical perspective, there is no compelling reason to believe that low real interest rates, by themselves, pose a particular risk to global economic and financial stability, as real interest rates should be driven by underlying forces to balance the global demand for saving and investment. Capital inflows from abroad can be beneficial if they are invested

³ The leading example of these policy discussions was the International Monetary Fund's Multilateral Consultation on Global Imbalances. Participants included China, the euro area, Japan, Saudi Arabia, and the United States.

⁴ This outcome is commonly referred to as the "global saving glut". See Ben S. Bernanke (2005), "The Global Saving Glut and the U.S. Current Account Deficit", speech delivered at the Sandridge Lecture, Virginia Association of Economics, Richmond, Va., March 10.

prudently. But in an environment in which the financial sector is prone to excess and the supervisory structure does not respond sufficiently, the interaction of low interest rates and financial vulnerabilities can clearly be dangerous. Notably, the generally stable macroeconomic environment that prevailed before the crisis may have exacerbated this problem, as it contributed to overly sanguine perceptions of risk.

Rather than financing productive business investment, capital inflows too often facilitated spending on housing and consumer goods. This circumstance was particularly true in the United States, where an innovative and entrepreneurial financial system aggressively competed for the opportunity to channel this capital to customers, in part by devising new and complex mortgage products. The resulting availability of funds and reduced interest rates boosted asset prices, particularly in the housing sector, and market participants assumed housing prices would continue to rise.

Moreover, the lower returns on conventional assets, including Treasury securities, fueled the demand for financial products with higher returns and fostered the buildup of leverage and risk. To some extent, this “reach for yield” may have been driven by a failure on the part of investors to recognize that the underlying equilibrium real interest rate had fallen, which implied that maintaining a given return on investment could only be achieved by accepting greater risk. At the same time, financial innovation created assets that seemed to improve the risk-return tradeoff, albeit in very complicated and opaque structures. The supply of these assets, which proved to be far riskier than understood at the time, was augmented by lax lending standards and inadequate supervision. The overall result was inflated asset prices, excess household debt, and a severe but underappreciated buildup of risk in the financial system to which the regulatory framework was ill-equipped to respond. In effect, we failed to heed the advice we so often gave to other countries – to be especially vigilant about the safety and soundness of the financial system when facing large capital inflows.

Thus, in my view, global imbalances contributed to important macroeconomic and financial vulnerabilities and, hence, to the emergence of the global financial crisis. Looking ahead, a more sustainable and balanced global economy in which the pattern of current account deficits and surpluses is more clearly determined by the efficient allocation of capital across borders is necessary to reduce the risks of future crises. Achieving better balance will require lasting shifts in spending, production, saving, and borrowing around the world.

The U.S. economy will need to be less driven by consumption and housing and will need to rely less on debt to finance spending on consumption and housing. And exports and capital investment will need to play a larger role in the economy. To some degree, this rebalancing is already happening. The U.S. current account deficit fell to 3 percent of GDP last year, about half the size of its previous peak. Part of this narrowing reflected a rise in household saving relative to disposable income. This higher saving rate should prove reasonably durable as households seek to pay down debt and rebuild wealth, and no longer count on house price appreciation as a substitute for saving out of current income. In contrast, the pickup in business investment as the economic recovery strengthens could well outpace any increase in business profits and saving, and part of the narrowing in the current account deficit could be reversed, absent other developments.

One of the steps to achieve rebalancing must be placing U.S. fiscal policy on a more sustainable path. At present, measured on a NIPA (national income and product accounts) basis, gross dissaving by the government sector represents about 6–3/4 percent of U.S. GDP. While much of this spending in excess of tax collections represents the transitory effect of the economic downturn, the aging of our population will pose severe challenges in the decades to come. And as we design fiscal reforms, we should look for opportunities to improve incentives for private saving.

So creating the sustained growth required to address the needs of future retirees will almost certainly involve increases in national saving. In a world in which the United States is no longer spending much more than it produces, countries that have become accustomed to

running large current account surpluses must learn to rely less on external demand and more on their own domestic demand. For these economies, the policy recommendations I discussed earlier continue to apply: structural reforms to boost domestic demand and potential growth and reduce excessive saving. For some economies, a rebalancing of demand toward domestic sectors will require significant changes in relative prices, and hence more flexible exchange rates will need to be part of the equation. These measures will not be undertaken solely to satisfy the ethereal principle of global rebalancing enunciated at countless meetings in international policy circles; instead, these measures will be undertaken because they are in the best interests of the countries themselves. In particular, more flexible exchange rates will help domestic demand fill in the gap left once foreign demand falls back to a more sustainable level. More flexible exchange rates also provide domestic policymakers greater scope to focus on domestic goals of full employment and price stability.

It is worth underscoring that even if authorities around the world aggressively undertake structural reforms that ameliorate current global imbalances, these actions will not preclude the emergence of large current account surpluses and deficits in the future. But the emergence of such imbalances should not necessarily be worrisome. As I noted earlier, in a world where different economies are periodically buffeted by different types of shocks, some of which may be quite persistent, cross-country dispersion in external balances is a perfectly natural way of smoothing the effects of these shocks over time.

What is important is to ensure that international capital flows do not combine with other weaknesses in the financial system to lay the groundwork for some future global crisis. Consequently, we need to work simultaneously on rebalancing global demand and strengthening the structure, operation, and governance of financial systems. Neither task is easy, but both are essential to a more stable world than the one we have experienced over the past few years.